

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFPH: [REDACTED]:2:POSTF-143617-02
[REDACTED]

date: August 22, 2002

to: [REDACTED], International Team Manager (LM:CTM: [REDACTED])

from: Associate Area Counsel (LMSB), [REDACTED]

subject: [REDACTED]
Debt-Equity Issue Regarding Advance to [REDACTED] Subsidiary

This memorandum addresses one of two debt-equity issues you asked our office to review. The issue addressed herein concerns a transfer of funds by [REDACTED] ([REDACTED]) to its [REDACTED] subsidiary, [REDACTED] ([REDACTED]). This memorandum should not be cited as precedent.

DISCLOSURE STATEMENT

This memorandum may contain privileged information. Any unauthorized disclosure of this memorandum may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

QUESTION

In transferring the equivalent of \$ [REDACTED] in [REDACTED] to [REDACTED] in [REDACTED], did [REDACTED] loan the amount to [REDACTED] or contribute the amount to [REDACTED]'s capital?

CONCLUSION

[REDACTED] (b)(5)(AC), (b)(5)(AWP) [REDACTED] did not appear to be undercapitalized. It used the funds to reduce debt owed to banks and other affiliates. It seemed to have enough cash flow and liquid assets to repay the advance. The advance had a fixed maturity date. And [REDACTED] had the right to enforce repayment. [REDACTED] (b)(5)(AC), (b)(5)(AWP)

[REDACTED] (b)(5)(AC), (b)(5)(AWP) [REDACTED] was not required to make an interest payment exceeding twenty percent of its statutory income before taxes and the amount of interest on the advance. [REDACTED] did not actually pay the interest. The interest was instead

added to the balance of the advance. [REDACTED] did not establish a sinking fund for repayment of the advance. [REDACTED] could not accelerate repayment in case of default on the principal or interest. [REDACTED] could convert the balance of the advance into common shares of [REDACTED] without payment of a premium. And the balance of the unpaid advance and the balance of the unpaid annual interest payments were subordinated to any debts of [REDACTED] in a winding up or termination of [REDACTED].

(b)(5)(AC)

(b)(5)(AC)

FACTS

[REDACTED] is a domestic corporation with headquarters in [REDACTED]. It owns or controls many foreign subsidiaries or operations, including [REDACTED]. Both [REDACTED] and [REDACTED] are in the business of discovering, developing, manufacturing, and selling [REDACTED].

According to its corporate minutes for [REDACTED], [REDACTED] authorized an increase in its capital from [REDACTED] to [REDACTED]. [REDACTED] received the new capital from [REDACTED] and reported this new capital in its audited financial statements for fiscal years ending [REDACTED] through [REDACTED].

Pursuant to a Memorandum of Agreement dated [REDACTED], [REDACTED] transferred to [REDACTED] an additional [REDACTED] (\$ [REDACTED]). In the Memorandum of Agreement, [REDACTED] and [REDACTED] agreed to the provisions as summarized below.

- [REDACTED] shall transfer to [REDACTED] (the advance).
- For each of its fiscal years, which ends [REDACTED] [REDACTED] shall make an annual interest payment to [REDACTED] in an amount equal to the product of (a) the balance of the advance, and (b) the average of the official discount rates determined by the [REDACTED]. [REDACTED] shall make such annual interest payment after the end of its fiscal year but before [REDACTED] of the following year. [REDACTED] shall not have to make an annual interest payment exceeding twenty percent of its statutory income before taxes and this annual interest payment.

- [REDACTED] shall have the option to convert the balance of the advance into common shares of [REDACTED] without payment of a premium, subject to all necessary approvals being obtained according to [REDACTED] company law to effect the requisite increase in common shares of [REDACTED].
- [REDACTED] shall repay the advance in [REDACTED], the statutory termination date for [REDACTED], or if the life of [REDACTED] should be extended, [REDACTED] shall repay the advance by the earlier of the new termination date or [REDACTED]. If it gives thirty days advance notice to [REDACTED], [REDACTED] may repay the advance early without payment of a premium as long as [REDACTED] does not choose to exercise its option in the preceding paragraph.
- In the case of a winding up or termination of [REDACTED], the balance of the unpaid advance and the balance of the unpaid annual interest payments shall be subordinated to any debts of [REDACTED].

[REDACTED] treated the advance as debt. In its audited financial statements for fiscal years ending [REDACTED] through [REDACTED], [REDACTED] reported the advance as long-term debt and reported the annual interest payments as accrued interest expense in the amounts of [REDACTED], [REDACTED], and [REDACTED], respectively. [REDACTED] also reported that it used some or all of the advance to reduce debt owed to banks and other affiliates. [REDACTED] did not make annual interest payments, at least through [REDACTED]. The interest was instead added to the balance of the advance. [REDACTED] did not mention the advance in its corporate minutes for [REDACTED] through [REDACTED].

In contrast, [REDACTED] treated the advance as equity. In its financial books for [REDACTED], [REDACTED] decreased a cash account by \$[REDACTED] and increased an investment-in-subsiary account by the same amount. In its income tax returns for [REDACTED] through [REDACTED], Forms 5471, [REDACTED] reported the financial condition of [REDACTED] but reclassified the way in which that company reported the advance. According to [REDACTED], it used U.S. generally accepted accounting principles to reclassify the advance from debt to equity. [REDACTED] reversed [REDACTED]'s accrued annual interest payments through retained earnings. [REDACTED] attached to its [REDACTED] through [REDACTED] tax returns a statement disclosing that the advance was being treated as equity for U.S. tax purposes and debt for [REDACTED] purposes. [REDACTED]

did not mention the advance in its corporate minutes for [REDACTED] through [REDACTED].

[REDACTED] seemed financially healthy according to its audited balance sheets and income statements for fiscal years ending [REDACTED] through [REDACTED]. It reported the following amounts for the items listed below (in nearest [REDACTED]).

	[REDACTED]	[REDACTED]	[REDACTED]
Fixed assets	[REDACTED]	[REDACTED]	[REDACTED]
Liquid assets	[REDACTED]	[REDACTED]	[REDACTED]
Customer receivables	[REDACTED]	[REDACTED]	[REDACTED]
Other assets	[REDACTED]	[REDACTED]	[REDACTED]
Total assets	[REDACTED]	[REDACTED]	[REDACTED]
Debt	[REDACTED]	[REDACTED]	[REDACTED]
Other liabilities	[REDACTED]	[REDACTED]	[REDACTED]
Equity	[REDACTED]	[REDACTED]	[REDACTED]
Total liab. & eq.	[REDACTED]	[REDACTED]	[REDACTED]
Interest payable			
to banks	[REDACTED]	[REDACTED]	X
to [REDACTED]	[REDACTED]	[REDACTED]	X
to other affiliates	[REDACTED]	[REDACTED]	X
Income before tax	[REDACTED]	[REDACTED]	[REDACTED]
Income after tax	[REDACTED]	[REDACTED]	[REDACTED]

On their surface, these financial statements suggest that there was sufficient cash flow and liquid assets to cover the annual interest payments and the repayment of the advance, especially if the advance matured in [REDACTED]. Through [REDACTED], [REDACTED] had not made an annual interest payment or repaid the advance. Nor had it established a sinking fund for the payment of the advance. [REDACTED] is still in the [REDACTED] products business.

You have preliminarily determined that the advance was debt. You propose to increase [REDACTED]'s interest income for [REDACTED] through [REDACTED] by an arms-length interest charge on the advance in the amounts of \$[REDACTED], \$[REDACTED], and \$[REDACTED], respectively. You determined the interest rate by using annual average lending rates found in International Monetary Fund, International Financial Statistics Yearbook ([REDACTED]) ([REDACTED]%, [REDACTED]%, and [REDACTED]% for [REDACTED] through [REDACTED], respectively). To these lending rates, you added a [REDACTED]% premium because the advance was unsecured and subordinate to other debt.

DISCUSSION

Whether a transfer of funds to a closely-held corporation is debt or equity depends on the facts and circumstances of each case. See Dixie Dairies Corp. v. Commissioner, 74 T.C. 476, 493 (1980). In resolving questions of debt versus equity, courts have identified and considered various factors. See, e.g., Estate of Nixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972) (13 factors); A.R. Lantz Co. v. United States, 424 F.2d 1330 (9th Cir. 1970) (11 factors); Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968) (16 factors); see also Calumet Indus., Inc. v. Commissioner, 95 T.C. 257, 285 (1990) (summarizing the factors).

The Court of Appeals for the Fifth Circuit has identified many of these factors as follows: (1) the name given to the certificate evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of payments, *i.e.*, whether the recipient of the funds can repay the advance with reasonably anticipated cash-flow or liquid assets; (4) whether the provider of the funds has the right to enforce payment; (5) whether the provider of the advance gains an increased right to participate in management; (6) the status of the contribution in relation to regular creditors; (7) the intent of the parties; (8) whether the recipient of the advance is adequately capitalized; (9) whether there is an identity of interest between the creditor and the shareholder; (10) source of interest payments, *i.e.*, whether the recipient of the funds pays interest from earnings; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the recipient used the advance to buy capital assets; and (13) whether the recipient repaid the funds on the due date. See Estate of Nixon v. United States, 464 F.2d at 402; see also Stinnett's Pontiac Serv., Inc. v. Commissioner, 730 F.2d 634, 638-40 (11th Cir. 1984); Laidlaw Transp., Inc. v. Commissioner, T.C. Memo. 1998-232.

The Court of Appeals for the Seventh Circuit, to which this case would be appealable, has not developed a similar list but has considered some of the same factors in various cases. See, e.g., Portage Plastics Co. v. United States, 470 F.2d 308, 312-13 (7th Cir. 1972); Sherwood Memorial Gardens, Inc. v. Commissioner, 350 F.2d 225, 229 (7th Cir. 1965); Charter Wire, Inc. v. United States, 309 F.2d 878, 880-81 (7th Cir. 1962); Arlington Park Jockey Club v. Sauber, 262 F.2d 902, 905-06 (7th Cir. 1959).

These factors are not equally significant, nor are they always relevant. See Dixie Dairies Corp. v. Commissioner, 74

T.C. at 493-94. They only assist in answering the debt-equity question. See Fin Hay Realty Co. v. United States, 398 F.2d at 697. In distinguishing debt from equity, the Seventh Circuit has said that "the essential difference between a creditor and a stockholder is that the latter intends to make an investment and take the risks of the venture, while the former seeks a definite obligation, payable in any event." Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182, 186 (7th Cir. 1942). According to the Tax Court, the ultimate question is, "was there a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship?" Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 377 (1973).

Below is a brief analysis of these factors in the context of this case.

1. The name given to the certificate evidencing the advance. The name may suggest debt or equity. See Estate of Mixon v. United States, 464 F.2d at 403. Here, the Memorandum of Agreement suggests neither. This factor is neutral.

2. The presence or absence of a fixed maturity date. A fixed maturity date tends to show the advance was debt. See Estate of Mixon v. United States, 464 F.2d at 404-05; Arlington Park Jockey Club v. Sauber, 262 F.2d at 906. In this case, there was a maturity date, but it was nearly as much fluid as fixed, since it could range from [REDACTED] (about [REDACTED] years) to [REDACTED] (about [REDACTED] years). This factor marginally shows that the advance was debt.

More information could further support your determination.

, (b)(5)(AC)

, (b)(5)(AC)

3. The source of payments, i.e., whether the recipient of the funds can repay the advance with reasonably anticipated cash

flow or liquid assets. Adequate cash flow and liquid assets tends to show the advance was debt. See Estate of Nixon v. United States, 464 F.2d at 405. According to its financial statements for fiscal years ending November [REDACTED] through November [REDACTED], [REDACTED] appeared to have enough liquid assets to pay the interest, although it did not. In addition, [REDACTED] appeared to have enough earnings to repay the advance if those earnings were put toward repayment, but it did not establish a sinking fund or otherwise reserve funds to repay the advance. Absence of a sinking fund tends to show the advance was equity. Charter Wire, Inc. v. United States, 309 F.2d at 881. (b)(5)(AC)

[REDACTED]
(b)(5)(AC)

[REDACTED]
(b)(5)(AC)

[REDACTED]
(b)(5)(AC)

[REDACTED]
(b)(5)(AC)

4. Whether the provider of the funds has the right to enforce payment. A fixed obligation to repay the advance tends to show the advance was debt. See Estate of Nixon v. United States, 464 F.2d at 405. Here, there was a fixed obligation to repay. This factor favors debt. On the other hand, the Memorandum of Agreement did not contain a provision for acceleration of repayment in case of default on the principal or interest. This favors equity. See Portage Plastics Co. v. United States, 470 F.2d at 313. In addition, the agreement allowed [REDACTED] to convert the balance of the advance into common shares of [REDACTED], without payment of a premium. This too favors equity. See Fin Hay Realty Co. v. United States, 398 F.2d at 696. (b)(5)(AC), (b)(5)(AWP)

5. Whether the provider of the advance gains an increased right to participate in management. Increased management rights tend to show that the advance was equity. See Estate of Nixon v. United States, 464 F.2d at 406. [REDACTED] owned and controlled [REDACTED] before and after the advance. This factor is neutral.

6. The status of the contribution in relation to regular creditors. An advance subordinated to general creditors tends to show the advance was equity. See Portage Plastics Co. v. United States, 470 F.2d at 313; Stinnett's Pontiac Serv., Inc. v.

Commissioner, 730 F.2d at 639. Under the Memorandum of Agreement, the balance of the unpaid advance and the balance of the unpaid annual interest payments were subordinated to any debts of [REDACTED] in a winding up or termination of [REDACTED]. This favors equity.

Other information may clarify the status of the advance.

[REDACTED]
(b)(5)(AC), (b)(5)(AWP)

7. The intent of the parties. This depends on whether contemporaneous facts, not testimony given years later, show an unconditional obligation to repay the advances. See Calumet Indus., Inc. v. Commissioner, 95 T.C. at 288 (citing Road Materials, Inc. v. Commissioner, 407 F.2d 1121, 1124 (4th Cir. 1969)). Here, the contemporaneous facts as developed thus far do not decisively favor debt or equity. This factor is neutral in this case.

Other documents and testimony may help show the intent of [REDACTED] and [REDACTED]. (b)(5)(AC)

[REDACTED]
(b)(5)(AC)

[REDACTED]
(b)(5)(AC)

8. Whether the recipient of the advance is adequately capitalized. Inadequate capitalization tends to show that the advance was equity. See Estate of Nixon v. United States, 464 F.2d at 408. Using the funds for items essential to the business also shows that the advance was equity. See Charter Wire, Inc. v. United States, 309 F.2d at 880. In this case, [REDACTED] seemed to have adequate capital. In its audited financial statements, [REDACTED] reported that it used some or all of the advance to reduce debt owed to banks and other affiliates. (b)(5)
(b)(5)(AWP), (b)(5)(AC)

[REDACTED]
(b)(5)(AC)

[REDACTED]
(b)(5)(AC)

, (b)(5)(AC)

9. Whether there is an identity of interest between the creditor and the shareholder. Advances are more likely equity if they are made by shareholders in proportion to stock ownership. See Estate of Nixon v. United States, 464 F.2d at 409; Charter Wire, Inc. v. United States, 309 F.2d at 881. [REDACTED] owned and controlled [REDACTED] before and after the advance. This factor is neutral.

10. Source of interest payments, i.e., whether the recipient of the funds pays interest from earnings. Payment of interest suggests that an advance is debt. See Estate of Nixon v. United States, 464 F.2d at 409. In this case, [REDACTED] did not make payments of the interest, at least through [REDACTED]. It instead added the interest to the balance of the advance. Furthermore, interest payable only out of net earnings before taxes suggests that the advance is equity. See Portage Plastics Co. v. United States, 470 F.2d at 313. Here, [REDACTED] was not required to make an annual interest payment exceeding twenty percent of its statutory income before taxes and the amount of interest. [REDACTED], (b)(5)(AWP), (b)(5)(AC)

, (b)(5)(AC)

, (b)(5)(AC)

11. The ability of the corporation to obtain loans from outside lending institutions. If the recipient of the advance can borrow from outside sources when it receives an advance, the advance is more likely to be debt. See Estate of Nixon v. United States, 464 F.2d at 410. [REDACTED] (b)(5)(AC), (b)(5)(AWP)

, (b)(5)(AWP), (b)(5)(AC)

, (b)(5)(AWP), (b)(5)(AC)

12. The extent to which the recipient used the advance to buy capital assets. An advance is more likely equity if used to purchase capital assets. See Charter Wire, Inc. v. United States, 309 F.2d at 880. In its audited financial statements,

[REDACTED] reported that it used some or all of the advance to reduce debt owed to banks and other affiliates. (b)(5)(AC), (b)(5)(AWP)

(b)(5)(AC), (b)(5)(AWP)

(b)(5)(AC), (b)(5)(AWP)

13. Whether the recipient repaid the funds on the due date. A failure to repay indicates the advance was equity. See Estate of Nixon v. United States, 464 F.2d at 410. In this case, the advance is not due yet. This factor is neutral.

(b)(5)(AC), (b)(5)(AWP)

[REDACTED] did not appear to be undercapitalized. It used the funds to reduce debt owed to banks and other affiliates. It seemed to have enough cash flow and liquid assets to repay the advance. The advance had a fixed maturity date. And [REDACTED] had the right to enforce repayment. (b)(5)(AC), (b)(5)(AWP)

(b)(5)(AC), (b)(5)(AWP)

[REDACTED] was not required to make an interest payment exceeding twenty percent of its statutory income before taxes and the amount of interest on the advance. [REDACTED] did not actually pay the interest. The interest was instead added to the balance of the advance. [REDACTED] did not establish a sinking fund for repayment of the advance. [REDACTED] could not accelerate repayment in case of default on the principal or interest. [REDACTED] could convert the balance of the advance into common shares of [REDACTED] without payment of a premium. And the balance of the unpaid advance and the balance of the unpaid annual interest payments were subordinated to any debts of [REDACTED] in a winding up or termination of [REDACTED].

(b)(5)(AC), (b)(5)(AWP)

(b)(5)(AC), (b)(5)(AWP)

Finally, we note that you based your adjustments on the annual average lending rates found in International Monetary Fund, International Financial Statistics Yearbook ([REDACTED]). We believe that those rates are reasonable guides for the appropriate arms-length charge for interest. (b)(5)(AC)

(b)(5)(AC)

(b)(5)(AC)

We have not coordinated this advice with an Industry Counsel because the issue does not appear to be within the scope of the responsibility of any Industry Counsel. For questions regarding this memorandum, please contact [REDACTED] extension [REDACTED].

Associate Area Counsel (LMSB), [REDACTED]

By: [REDACTED]

Attorney

cc: James C. Lanning, Area Counsel
[REDACTED], Senior Legal Counsel
[REDACTED], Associate Area Counsel
[REDACTED], Associate Area Counsel
[REDACTED], Associate Area Counsel ([REDACTED])